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Retention of Extensive Powers Not Cause for Estate Taxation of a Trust

M. Louise Everett

Retention of Extensive Powers Not Cause for Estate Taxation of a Trust

Decedent had placed the stock of three closely held corporations in an irrevocable trust. He had previously controlled the corporations, and he retained the right to vote the transferred stock, to veto the transfer of any stock by the trustee, and to remove the trustee and appoint another corporate trustee as successor. The Commissioner of Internal Revenue determined that the transferred stock was includable in his gross estate under section 2036(a) of the Internal Revenue Code.[1] Decedent's executrix paid the additional tax and brought suit for a refund in federal district court. The court ruled for the executrix.[2] The Court of Appeals for the Sixth Circuit affirmed.[3] The Supreme Court granted certiorari.[4] *Held, affirmed*: The decedent did not retain the right, within the meaning of section 2036(a)(2), to designate who was to enjoy the trust income, and the decedent's voting control of the stock did not constitute retention of the enjoyment of the transferred stock within the meaning of section 2036(a)(1), so that the transferred stock was not includable in the gross estate of the decedent. *United States v. Byrum*, 408 U.S. 125 (1972).

I. THE FEDERAL ESTATE TAX

A death tax is the price paid for the privilege of transmitting property at death, and although the tax is measured by the value of the property transferred at death, the tax is actually upon the transfer of the property rather than the property itself.[5] Death taxes are divided into estate and inheritance taxes, the former being for the privilege of transferring property and the latter being for the privilege of receiving property.[6] The federal tax established by the Internal Revenue Code is an estate tax. Sections 2036(a)(1) and (2) of the Code are concerned with reservation of a life interest in the corpus of transferred property.[7]

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[1] INT. REV. CODE of 1954, § 2036.

[2] Byrum v. United States, 311 F. Supp. 892 (S.D. Ohio 1970).

[3] 440 F.2d 949 (6th Cir. 1971).

[4] 404 U.S. 937 (1971).

[5] C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 3 (1956).

[6] *Id.* at 4. The Internal Revenue Code attempts to tax all transfers passing at death regardless of the form in which the transfer is made. The estate tax consequences of transfers by will and intestacy, dower and curtesy and their statutory substitutes, transfers in contemplation of death, transfers taking effect at death, transfers with a reservation of a life interest, revocable transfers, annuities, survivorship in joint estates, powers of appointment, and life insurance are detailed in INT. REV. CODE of 1954, §§ 2033-42.

[7] Section 2036 provides in part:

> (a) General Rule—The value of the gross estate shall include the value of all property . . . of which the decedent has at any time made a transfer . . . under which he has retained for his life . . .
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> (1) the possession or enjoyment of, or the right to the income from, the property, or
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> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Also on point is Rev. Rul. 67-54, 1967-1 CUM. BULL. 269. In a fact situation similar to *Byrum*, stock held in trust could not be sold without the consent of the settlor, who retained the right to vote the stock. The ruling states: "Since the grantor retained the power to regu-

Section 2036(a)(1): Enjoyment of the Property. "Enjoyment" as used in this subsection denotes a present, substantial economic benefit.[8] Many trusts which are taxed under this subsection involve the retention by the settlor of title, right to income, or the right to use real property for his lifetime.[9] Other reasons for inclusion of a trust are use of trust income to discharge the obligation of the settlor to support the beneficiary and retention of an interest in the family residence given to a spouse.[10] However, substance rather than form controls[11] so that while the settlor might not retain an interest in the trust instrument, an understanding, express or implied, that the interest would be conferred later will cause inclusion of the trust in the estate.[12]

Section 2036(a)(2): Right To Designate Income Beneficiaries. Among the reserved powers causing a trust to be included in the gross estate of a settlor under section 2036(a)(2) are the powers to shift beneficial interest from one person to another,[13] to accumulate income in the trust,[14] to withhold or accelerate distribution of principal,[15] to designate whether an extraordinary item is principal or income,[16] and to terminate the trust.[17] If the powers of the trustee may be exercised only with the consent of the settlor the trust may be included in the gross estate.[18] However, several cases have indicated that the retention of certain broad powers by the settlor is not likely to result in the trust being taxed as part of the estate. The powers include determining in-

late the income from the transferred property, he retained for his life or for a period which did not in fact end before his death the right to designate the persons who shall possess or enjoy the property or the income therefrom."

[8] Commissioner v. Estate of Holmes, 326 U.S. 480 (1946).

[9] *See, e.g.*, Lober v. United States, 346 U.S. 335 (1953); Commissioner v. Estate of Church, 335 U.S. 632 (1949); Estate of Holland v. Commissioner, 47 B.T.A. 807, *modified*, 1 T.C. 564 (1943). The rationale of these cases is given in *Church*: "[A]n estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property." 335 U.S. at 645.

[10] Commissioner v. Dwight's Estate, 205 F.2d 298 (2d Cir.), *cert. denied*, 346 U.S. 871 (1953); Estate of Lee v. Commissioner, 33 T.C. 1064 (1960). *But see* Estate of Gutchess v. Commissioner, 46 T.C. 554 (1966), in which a residence put in trust for the grantor's spouse was not includable in the gross estate. *See generally* Rossbach, *Gifts With Retained Life Estates Including the Use of Property: Income and Estate Tax Consequences*, N.Y.U. 25TH INST. ON FED. TAX. 1077 (1967).

[11] *See, e.g.*, Note, *Application of Sections 2036(a)(1)-(2) to Transfers in Trust of Stock in Closely Held Corporations*, 46 TUL. L. REV. 1038 (1972).

[12] Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied*, 361 U.S. 829 (1959).

[13] Cook v. Commissioner, 66 F.2d 996 (3d Cir. 1933), *cert. denied*, 291 U.S. 660 (1934).

[14] United States v. O'Malley, 383 U.S. 627 (1966). *But see* Commissioner v. Estate of McDermott, 222 F.2d 665 (7th Cir. 1955). Accumulated income was held not taxable even though the corpus was taxable.

[15] Lober v. United States, 346 U.S. 335 (1953).

[16] *See, e.g.*, Estate of Downe, 2 T.C. 967 (1943); Estate of O'Neal, 6 CCH Tax Ct. Mem. 713 (1947). *See generally* Comment, *Inclusion of Trust Corpus in Settlor's Taxable Estate Where Administrative Powers Are Held in Fiduciary Capacity*, 32 ROCKY MT. L. REV. 223 (1960).

[17] *See, e.g.*, Commissioner v. Estate of Holmes, 326 U.S. 480 (1946); Reinecke v. Northern Trust Co., 278 U.S. 339 (1929).

[18] *See, e.g.*, Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935); Estate of O'Neal, 6 CCH Tax Ct. Mem. 713 (1947) (power to "control" trust investments); Estate of Downe, 2 T.C. 967 (1943) (power to direct trustee to issue voting proxies, retain, sell, exchange, invest, and reinvest trust assets).

vestment of trust assets, determining which charges are against income and which are against principal, and acting as a trust advisor in a limited capacity.[19]

II. United States v. Byrum

The View of the Court. In its analysis of section 2036(a)(1) the Court held that the decedent's voting control of the stock did not constitute retention of the enjoyment of the transferred stock within the meaning of this section since the decedent had irrevocably transferred the title to the stock and the right to the income.[20] It was argued that this was not a present benefit, but rather a speculative and contingent one. The Court would have been on much firmer ground if it had limited its reasoning to the contention that the settlor did not retain present enjoyment of the property by continuing to work for the corporations and retaining voting control. To be guaranteed employment is not unusual for a majority shareholder of a close corporation.[21] Byrum quite possibly would have been employed by one or all of the corporations on the strength of his past employment and retained holdings. His income was based on services rendered. That is not the type of enjoyment with which the Court was concerned. Enjoyment, within the meaning of section 2036(a)(1), has been construed by the courts as involving an incomplete delivery, a revocable transfer, or a retention of the right to income.[22] Only one case[23] cited by the Government involved the retention of the right to vote transferred stock, but it involved a much larger retained interest than did *Byrum.*[24] Whether the right to vote the transferred stock was enjoyment of the property within the meaning of the statute was a close question. There were no cases directly on point. The Court reasoned that since there was no precedent for taxing the estate due to retention of this specific interest, such a precedent should not be established. Due to the importance of being able to rely on stare decisis, property law is seldom changed, and the Court reasoned that trusts were analogous to property in this respect. However, since there was no previous case law, the Court actually set precedent in *Byrum.* Therefore, this would appear to be a very questionable basis for the decision.

The Court concluded that under section 2036(a)(2) retention of broad management powers would not necessarily subject an *inter vivos* trust to the federal estate tax and that the right to vote a majority of the stock in the three corporations did not give the decedent de facto power to accumulate income

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[19] *See, e.g.,* Estate of King v. Commissioner, 37 T.C. 973 (1962); Estate of Peters, 23 CCH Tax Ct. Mem. 994 (1964); Estate of Wurts, 19 CCH Tax Ct. Mem. 544 (1960).

[20] 408 U.S. at 132.

[21] For a discussion of employment contracts of shareholders in close corporations, see H. Henn, Law of Corporations 547, 571 (2d ed. 1970).

[22] *See, e.g.,* United States v. Estate of Grace, 395 U.S. 316 (1969); Lober v. United States, 346 U.S. 335 (1953); Commissioner v. Estate of Church, 335 U.S. 632 (1949); Estate of McNichol v. Commissioner, 265 F.2d 667 (3d Cir.), *cert. denied,* 361 U.S. 829 (1959).

[23] Estate of Holland v. Commissioner, 47 B.T.A. 807 (1942), *modified,* 1 T.C. 564 (1943).

[24] The decedent retained a salary for life not related to services rendered but calculated to provide a 20% return on investments. The decedent also prohibited the beneficiaries from selling stock. *See* Ehrlich, *Current Developments Involving Non-Voting Stock in Estate Planning,* N.Y.U. 26th Inst. on Fed. Tax. 1275 (1968).

in the trust.[25] The Court cited *Reinecke v. Northern Trust Co.*[26] and *Estate of King v. Commissioner*,[27] although neither was cited as controlling this case.[28] However, probable reliance on these decisions by draftsmen over the years plus the fact that *Northern Trust* has never been overruled were convincing to the Court.[29] It was reasoned that if the law is to be changed it should be done by Congress rather than by the Courts.[30]

A majority shareholder has a fiduciary duty not to misuse his power, and directors have fiduciary duties to promote the interests of the corporation.[31] Thus, it was argued, the right to control dividends was not legally enforceable.[32] The rationale was that there was no predictability of earnings to accumulate or from which to declare dividends.[33] The precedents relied upon by the Government—*Lober v. United States*[34] and *Commissioner v. Estate of Holmes*[35]—were distinguished as turning on the power to terminate a trust, which is clearly a different power. Excess accumulation of earnings taxes and potential shareholders' derivative suits were relied upon as deterrents to any devices which the settlor might have employed to designate the income beneficiaries through manipulation of dividends. The faith given to the power of these deterrent forces was a weak link in the Court's reasoning.[36]

The Dissenting View. When faced with the issue of enjoyment of the transferred stock within the meaning of section 2036(a)(1), the dissent focused on the vague term "control." The dissent argued that by retaining control Byrum guaranteed his own employment and the right to determine if the corporations should be liquidated or merged. Thus the decedent controlled a close corporation for his lifetime, which was characterized as a substantial, present economic benefit.[37] The dissent did not define control.[38] Even if this

[25] 408 U.S. at 139-44.

[26] 278 U.S. 339 (1929).

[27] 37 T.C. 973 (1962).

[28] *Northern Trust* was not decided under § 2036 or its predecessor, and *King* was a tax court decision.

[29] "The holding of *Northern Trust*, that the settlor of a trust may retain broad powers of management without adverse estate tax consequences may have been relied upon in the drafting of hundreds of *inter vivos* trusts." 408 U.S. at 134.

[30] The argument was that Congress can better determine the precise type of conduct which results in tax consequences, and congressional action will give taxpayers advance warning.

[31] *See* H. HENN, LAW OF CORPORATIONS 416 (2d ed. 1970).

[32] 408 U.S. at 137.

[33] The Court listed reasons why a corporation might not have earnings: bad years, product obsolescence, new competition, disastrous litigation, new regulations. Further, a close corporation has less access to capital and may need to be more conservative than a large corporation in its dividend policy. It may have to plow earnings back into the corporation rather than using them as a source of dividends. 408 U.S. at 139.

[34] 346 U.S. 335 (1953).

[35] 326 U.S. 480 (1946).

[36] As the dissent explained, there are penalty taxes for excess accumulation of earnings, but the penalty takes effect only when accumulations exceed $100,000. INT. REV. CODE of 1954, § 531. This would have been little restraint on the settlor's control of dividend policy. Further, the threat of a shareholder's derivative suit would have been only a slight deterrent to accumulation of earnings since few such suits succeed. *See* W. CARY, CASES AND MATERIALS ON CORPORATIONS 1587 (4th ed. 1969).

[37] 408 U.S. at 152 (White, Brennan, Blackmun, JJ., dissenting).

[38] *Id.* It should be noted that the Government did not rely on any definitions of control such as that in Treas. Reg. § 1.351-1 (1971). It reads in part: "To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 per cent of the total combined voting power of all classes of

vague term is to be accepted as the standard for determining taxability of the trust, a distinction should have been made between the corporation in which Byrum controlled a majority of the shares in any case, and the corporations in which he retained control of a majority of the shares only if he had the power to vote the transferred shares. The dissent did not consider this possibility. The definition of "control" was far less specific than the meanings given to "enjoyment" as used in section 2036(a)(1) by the courts.[39] Consequently, the argument of the dissent was weakened by its failure to adequately define "control."

The dissent relied primarily upon the contention that since the settlor retained the right to vote a majority of the shares in all three corporations he retained de facto control over corporate dividend policy. Control over dividend policy allowed the settlor to shift income from the life estate to the remainder by retaining earnings rather than declaring dividends. This was equated with the power to accumulate income in the trust,[40] which in turn constituted the power to designate beneficiaries. To accept the conclusion of the dissent, one must first accept its premise that the right to vote a majority of the shares was equivalent to control over corporate dividend policy.[41]

III. CONCLUSION

The powers which a settlor of an irrevocable trust may retain without making the trust includable in his gross estate have been greatly expanded by *Byrum*. Even a narrow construction of the holding would allow retention of broad management powers including the right to vote transferred stock. Further, the Court indicated an intention to preserve the status quo by not including a trust in the grantor's gross estate for tax purposes if the retained powers had not previously been held to have constituted retention of a life interest. This leaves quite a loophole for tax-conscious settlors. It will be necessary for Congress to eliminate the loophole through legislation, if the congressional intent is to tax this type of trust. Since Congress did not move swiftly to change the law it may be that it approves of the loophole. Congress might also wish to define more clearly the terms "designation of the persons who shall possess or enjoy" and "possession or enjoyment," since under the present interpretation it is apparent that the Government is losing revenue.[42]

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stock . . . ." The accounting standard of 20% ownership constituting control was also not considered. 1 APB ACCOUNTING PRINCIPLES § 5131.17 (1971).

[39] *See* note 22 *supra*, and accompanying text.

[40] "Thus, by instructing the directors he elected in the controlled corporations that he thought dividends should or should not be declared Byrum was able to open or close the spigot through which income flowed to the trust's life tenants." 408 U.S. at 152.

[41] *See* note 7 *supra*. The dissent relied upon Rev. Rul. 67-54, while the majority ignored it. However, a revenue ruling is merely a statement of the position of the Government and does not have the force of law.

[42] A month after *Byrum* was decided it was relied on by a lower court in a case involving § 2036(a)(2). The grantor retained the right to direct investments in conjunction with the trustees. The court held that he did not retain the right to designate persons who shall possess or enjoy property or its income. Estate of Chalmers, CCH TAX CT. REP. Dec. 31,-473(m) (July 27, 1972).